Is Russia's balanced budget a miracle? The effects of raised commodity prices

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Zusammenfassung

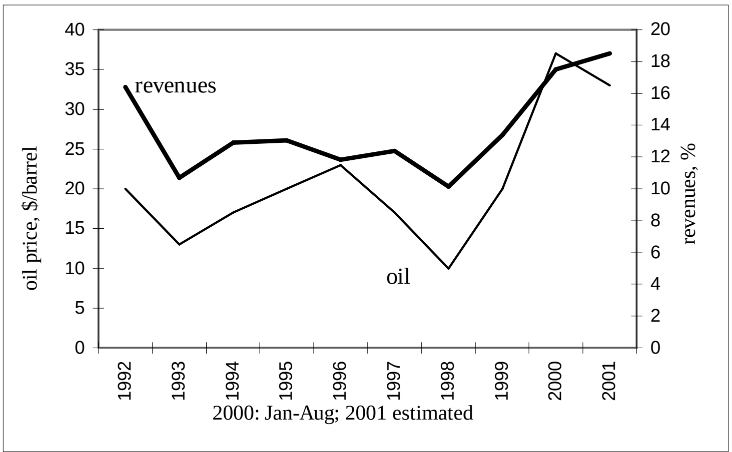
Die starke Abwertung des Rubels und der jüngste Wertzuwachs der Exporte haben für Entspannung bei den russischen Staatsfinanzen gesorgt. Allerdings nimmt der Effekt steigender Exporterlöse auf die Haushaltseinnahmen ab. Auch der wachsende Leistungsbilanzüberschuß deutet eher auf eine noch fragile Belebung hin, da die volkswirtschaftliche Ersparnis offensichtlich nicht effizient genuzt wird. Obwohl das Budget in guter Verfassung ist, bleibt die Inflationsrate zu hoch. Dafür ist der massive Fremdwährungszufluß verantwortlich, aber seine Einschränkung würde wiederum den Budgetsaldo in Gefahr bringen. Um die außenwirtschaftliche Abhängigkeit zu verringern, müssen folglich unter Ausnutzung der gegenwärtigen Wachstumsphase die Reformen auf der Mikroebene beschleunigt werden.

Primary effects: budget revenues

The stunning performance of the Russian government's budget in the last two years has triggered a discussion about how sustainable the current situation of sound finances might be. After all, this is a country with a poor record of fiscal discipline. Yet since 1998 budget data have suddenly improved. Tax collection, especially, has become much more satisfactory, despite the lack of new tax legislation (this came into force only in August, 2000). The devaluated ruble was largely responsible for a revival of the competitiveness of sectors supplying the domestic market, especially the food processing industry. The improved prospects here and the lack of portfolio investment opportunities after the closure of the bond market in the fall of 1998 made the sector, with its relatively short cycles of capital turnover, attractive to investors and helped to improve its competitiveness. The revitalized firms started paying more taxes and contributed to overcoming the "Russian disease," – i.e., the notoriously high level of tax evasion.

But it was not just the ruble devaluation that helped to feed the budget. Budget data show that the country's finances are heavily dependent on international energy prices. As price hikes took place revenues rose too, because of the enlarged tax base; conversely, there is a danger that a price collapse would cause a budget imbalance again.[1] Such fears seem justified by history: the share of federal budget revenues in GDP increased in January-June 2000 to 17.1 per cent, whereas they were only 11.1-13.5 per cent between 1996 and 1999.[2]

Diagram 1: Spot crude oil prices in US dollars per barrel, and federal budget revenues as a percentage of GDP



Sources: BP, www.bpamoco.com; Russian Economic Trends (RET), www.hhs.se/site/ret, Table 11

However, in the early 1990s only a loose link between oil price changes and the decline in budget revenues can be discerned (Diagram 1). Only after 1998 did the rise in oil prices and the improvement in the fiscal constitution of the Russian Federation display a much closer correlation. This becomes apparent when one looks at the budget on a month-to-month basis: since 1999 unit price growth has in principle yielded a positive rise in government revenues. Thus, the elasticity of budget revenues with respect to the oil price has been positive. That said, the budget increase gained from export revenues has been less than a unit – i.e., each ruble of additional export revenue has contributed only a fraction of a ruble to the budget, recently roughly one half. So for the government to raise further funds commodity prices would need to rise by an excessive amount, which does not seem realistic. Yet from the viewpoint of federal finances there is a positive element in this constellation too: once prices start to fall, revenues will fall less. The overall stability of the budget will not be jeopardized immediately and it will have more time to adapt (Diagram 2).

Thus, the first conclusion might be that the Russian state has profited from the recent windfall in export gains. The second conclusion follows from the first: namely, that the improvements on the macro level must be transferred to microeconomics. Otherwise, when another systemic crisis, such as that of 1998, looms the budget will be in a mess again. However, reforms require time to be implemented, so for the time being and for the foreseeable future the budget may remain volatile, since the link to trade revenues is pretty apparent.

1 The budget balance also benefited from the reshaped expenditure structure. For instance, additional relief to the federal budget was brought by the write-off by the London club of creditors in February 2000 of one-third of the country's debt to commercial lenders.

2 Banking & Finance, Interfax Information Services B.V. weekly report, September 8, 2000, p. 8.

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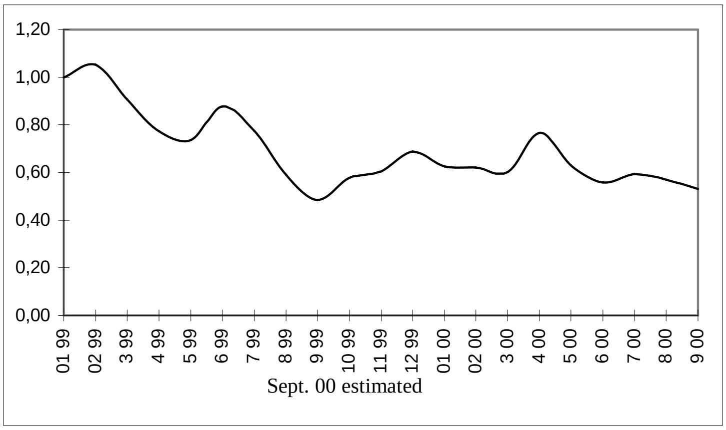
Diagram 2: Elasticity of the budget revenues with respect to the oil price 1999-2000



Sources: The Economist Intelligence Unit, June, 2000, pp. 5, 23; BP; RET, Table 11

A big trade surplus is not a blessing

Not only has the budget improved but output (GDP) is rapidly expanding by an estimated rate of 5-5.5 per cent in 2000. Moreover, the current account, that is, exports minus imports minus the interest payments on credits from foreign lenders, is about to hit a record of roughly 6 per cent of GDP this year.[3] Last, but not least, investment is reported to have gained enormous momentum. Yet the current account or, put another way, the huge trade surplus poses an increasingly complex situation. For when an economy is emerging rapidly from a long-lasting depression, a modernization of capital stock is under way, and the current account surplus quickly turns into a deficit. There is nothing worrisome about this, since it usually reflects a higher demand for capital goods, which boosts output further and secures sustained growth. Investors thus gain confidence and are willing to extend credits to the economy to close the gap between export revenues and import expenditures. Even advanced economies may find themselves in such a situation. For instance, the US is currently growing at a faster pace than the rest of the industrialized world, so it is able to attract enough foreign investment to finance its widening trade deficit with no negative impact on the exchange rate.

The key point in Russia is the positive budget balance, which means there is a real government saving. Taken together with the relatively low household savings and somewhat larger savings in the business sector, this has meant an overall increase in the savings rate in Russia in 2000. Technically, these savings are being used for investment at home and abroad, the latter being nothing other than the current account (or trade balance). A positive current account reflects lending abroad, since only a fraction of the overall savings has been used to finance domestic investment. Conversely, a negative current account reflects an influx of direct and/or portfolio investment by foreigners.[4] In Russia the net export revenues have been used recently mainly to replenish the depleted foreign exchange reserves. As a re-

3 At purchasing power parities (ppp). Calculated with respect to expected net exports of $60 billion and a GDP at PPP of $971 billion. Sources: State Customs Committee, quoted by Banking & Finance, Interfax Information Services, September 1, 2000, p. 4; Roland Götz: Struktur, Größe und Entwicklung des russischen Bruttoinlandsprodukts 1995-1999 unter Berücksichtigung von Kaufkraftparitäten, Berichte des BIOst, Nr. 21/2000, Table 11.

4 As foreign credits are needed to finance net imports.

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sult they have more than doubled since the fall of 1998.[5] But it would have been better to reduce the trade surplus and to raise investment in fixed capital instead. Although it reportedly expanded by 14 per cent between July 1999 and July 2000,[6] the investment rate remains low. It was about 10 per cent of GDP in 1999 and may have risen to 11 per cent this year. Although this is an improvement, it is a poor record by international standards.

The still widening gap between exports and imports may reflect a persistent mood of skepticism on the micro level concerning the development of the economy in the next few years. Since direct investment, that is, the acquisition of new capacity and equipment, requires a longer time horizon, investors may wait for more details about how the government is going to tackle an array of unsolved problems. These include business taxation, the exchange rate policy of the Central Bank, the enforcement of property rights by the courts, corruption in the administration and the like. So right now the economy seems to be running well on its own by relying on a better capacity utilization, while investment, although expanding, has not reached the required level yet. Consequently, a setback in exports would be a blow to the economy as a whole, which remains vulnerable to price fluctuations on international markets.

The dollar inflow increases pressure for reforms

While inflation in 2000 and 2001 is expected to reach 20 and 16 per cent, respectively[7], the planned nominal ruble-dollar exchange rate does not adjust to inflation and the ruble will appreciate in real terms. On the other hand, the dollar deluge is likely to go on if the monetary authorities stick to the required purchasing level of 75 per cent of export revenues. Both tendencies are likely to pose a dilemma and at present there is no clear idea of how the Central Bank will deal with it.

Firstly, as long as the budget balance is healthy there is no reason to expand the money supply to a level that would produce double-digit inflation. While the growth in output was fairly negligible, the monetary base picked up between mid-1999 and mid-2000 by almost 50 per cent. Whether there is a wage-price spiral under way is not clear yet, but the fact that nominal wages rose by about 50 per cent in the first half of 2000 seems to indicate that there is. If this indeed proves to be the case, the newly gained confidence in the stabilization commitment of the authorities may fade, with negative consequences for investment and growth.

Secondly, the Central Bank may push up the value of the ruble and reduce the inflationary pressure resulting from rapid growth in the money supply. But a cheaper dollar will harm the export sector, branches relying on import competition, and the budget as well. Another effect will be reduced capital imports, since the incentive to understate revenues or to engage in capital flight again is likely to rise. The reason for this is that exporters will become increasingly reluctant to obtain fewer rubles per dollar in nominal terms and will try to hide the actual amounts they earn in trade. But increasing capital flight will hamper the ability of the state to service its foreign debt and will make it difficult for Russia to return to the international capital markets.

Thus, the conclusion is that the present favorable situation of "easy dollars" and improved budget indicators should be used to accelerate business reform on the micro level. Foreign direct investment must be encouraged and public investment programs should be given priority in budget expenditure. The net export revenues should be channeled to firms to raise their investment in fixed capital and to secure sustained growth. The best way to transfer the export dollars to the economy is to promote more

5 From $11.8 billion to $30 billion by the end of this year.

6 Source: State Committee for Statistics, quoted by Banking & Finance, Interfax Information Services, August 18, 2000, p. 7.

7 The Economist Intelligence Unit forecast, June 2000, p. 6ff.

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lending by the banking system, which has been ailing since 1998. But recently bank excess reserves have started to rise, as the banks are supposed to sell dollars to the Central Bank for rubles, while firms prefer to rely on their own funds instead of bank credits. For their part, the banks hesitate to extend credits because of a lack of protection for creditors and poor enforcement of the bankruptcy law. To persuade the economy to draw more credit means boosting the money multiplier too. This would help to overcome the notorious demonetization of the Russian economy. With more credit available interest rates will continue to fall, allowing even faster growth.

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